"The PATH Home: How to Create a Sustainable Housing Finance System for America"

House Financial Services Chairman Jeb Hensarling provided the following keynote address at the Bipartisan Policy Center Housing Commission's Regional Forum at the George W. Bush Presidential Center on August 13, 2013:

I want to thank the Bipartisan Policy Center for the work it has done on housing finance reform. I especially want to recognize the outstanding leadership and service of people like Secretary Martinez and Secretary Cisneros.

Thank you, gentlemen, for continuing to serve our nation by promoting solutions to our nation's housing challenges. I commend you.

Let me also thank the Center for promoting a respectful and constructive dialogue on this subject. I'm pleased to be part of that dialogue today.

As some may know, I have focused a good portion of my time in public office to the issue of housing. The goal of homeownership is an especially cherished American tradition – a tradition far more meaningful than well-landscaped lots, picket fences, or granite countertops. Homeownership can indeed bind families together, build financial security and strengthen communities.

But as cherished of an institution as it may be, homeownership does not in and of itself constitute the American Dream. The American Dream is something far more profound – quite simply, the right to use our God-given talents to control our own destinies to the end that our children can have even greater opportunities, greater abundance, and greater freedoms than we have enjoyed.

It is this understanding of the American Dream that serves as my compass in this debate. And before we can use this compass to chart a path for the future, we must first have a thorough understanding of where we have been and where we unfortunately find ourselves today.

From my work on the Congressional Oversight Panel for TARP, it became clear to me that the great tragedy of the financial crisis was not that Washington failed to prevent the crisis, but instead that Washington helped lead us into it. And we were led into it based upon a single good intention -- namely, that every American family should own a home.

Washington helped lead us into the crisis in three principal ways:

- First, federal policies were designed to expand home ownership in an "off-budget" fashion by encouraging lending to people who bought homes they could not afford to keep. Sadly, a federal government which lives beyond its means in turn tragically encouraged American families to do likewise.
- Secondly, Washington promoted moral hazard by protecting Fannie Mae and Freddie Mac, which privatized profits and socialized losses.
- And lastly, the Federal Reserve maintained a highly accommodative monetary policy that dramatically lowered interest rates, kept them low, and inflated the housing bubble.

The Fed set the stage for a wave of mortgage borrowing by keeping credit conditions too loose for too long. With the bursting of the high-tech bubble in 2000, the Fed began lowering interest rates in early 2001 to cushion the economic fallout. On an inflation adjusted basis, the Fed dropped interest rates from 4 percent in late 2000 to negative 1.5 percent by early 2003. That decision unleashed a wave of cheap credit on a housing market that was already experiencing a boom cycle.

Next, the federal government has for decades attempted to spur lending and borrowing to expand homeownership without direct taxpayer spending – and, therefore, annual congressional approval.

One of the most damaging of those initiatives has been the Community Reinvestment Act, which was undertaken with good intentions but is antiquated and in need of repeal.

Proponents of CRA-like mandates have maintained that only a small portion of subprime mortgage originations are related to the CRA. However, that misses the fundamental point. Though they may be small in volume, CRA loan mandates remain large in precedent. They inherently required lending institutions to abandon their traditional underwriting standards to comply with this government mandate. And CRA implicitly put the government's Good Housekeeping Seal of Approval on such loans.

Finally, Fannie Mae and Freddie Mac -- private companies awarded monopoly powers by Congress in exchange for meeting certain affordable housing goals. They exploited those congressionally-granted charters to borrow at discounted rates and ultimately dominated the secondary mortgage market. They wildly inflated their balance sheets and personally enriched their executives via implicit -- now explicit -- government backing, not to mention via the "cooked books" that allowed politically-connected executives to make off like bandits with what their regulator described as "ill-gotten bonuses in the hundreds of millions of dollars."

Given their prominence in the market, investors and underwriters came to believe that if Fannie or Freddie touched a loan, it was safe, sound, secure and, most importantly, "sanctioned" by the government.

More than 70 percent of subprime and Alt-A mortgages that led to the crisis were backed by Fannie and Freddie, FHA, and other taxpayer-backed programs. If you have to point to a root cause of the financial crisis, this is it.

Despite the inherent dangers in such transactions, Fannie and Freddie's congressional supporters kept encouraging them to "roll the dice a little bit more". Well, they did, and the result is the mother of all bailouts: nearly $200 billion and the worst financial crisis since the Great Depression.

Again, the ultimate consequence of these policies was the average American family watched helplessly as their net wealth declined by nearly $50,000, wiping out almost two decades of financial progress.

Ladies and gentlemen, that is where we have been. And five years later, where do we find ourselves?

Today, there are single moms working even harder than before simply to put food on the table for their children and a roof over their heads. That's unconscionable.

Today, taxpayers have been forced to pay for the mother of all bailouts -- nearly $200 billion for the failed GSEs. That's unimaginable.

Today, taxpayers remain on the hook for more than $5 trillion in mortgage guarantees, roughly one-third the size of our economy. That's unfathomable.

Today, the federal government has a virtual monopoly on the housing finance system. That's unwise.

Today, due to the Dodd-Frank Act, Washington elites decide who can qualify for a mortgage, putting homeownership out of reach for millions of credit-worthy American families. That's unfair.

The American people deserve a path forward. They deserve a path to a housing system that is sustainable,

fair, and protects the American Dream.

They deserve a system that protects current and future homeowners, so every American who works hard and plays by the rules can have opportunities and choices to buy homes they can actually afford to keep.

They deserve a system that protects hardworking taxpayers, so they never again have to bail out corrupted government-sponsored enterprises like Fannie Mae and Freddie Mac.

They deserve a system that finally breaks the destructive boom-bust housing cycles that have hurt so many working families and brought our economy to its knees.

That's why the House Financial Services Committee recently approved the PATH Act – whose acronym stands for Protecting American Taxpayers and Homeowners. The PATH Act is the path forward. The Act is the principal work of Scott Garrett of New Jersey, and Randy Neugebauer of Texas and Shelley Moore Capito are its coauthors. I commend their principled leadership for bringing this landmark legislation to our committee.

At its core, the housing market is not fundamentally different from the market for any other asset. Housing is not immune to the economic laws of supply and demand or risk and reward. Thus, the PATH Act principally relies upon private capital and market discipline. It includes four fundamental goals essential to the development of any free market.

First, the role of government is clearly defined and limited.

Second, artificial barriers to private capital are removed to attract investment and encourage innovation.

Third, market participants are given clear, transparent, and enforceable rules for transactions to foster competition and restore market discipline.

Lastly, consumers are afforded informed choices in determining which mortgage products best suit their needs.

The Act specifically:

- Ends the costly Fannie and Freddie bailout;
- Protects and restores the FHA by defining its mission;
- Increases mortgage competition, enhances transparency, and maximizes consumer choice; and
- Breaks down barriers for private investment capital.

The first step to creating a sustainable housing finance system is to end the costly bailout of Fannie and Freddie and permanently move away from a system where the fate of our economy depends upon their success or failure. The PATH Act ends the bailout and gradually winds down both failed companies over a five to seven year timeframe.

Much has been said in this debate about the so-called "need" to have GSEs or their equivalent in our housing finance system.

First, we should recognize that the U.S. is practically alone in the modern industrialized world in having GSEs directly guarantee mortgage securities. We are practically alone in the level of direct government subsidy and intervention into our housing market. We were also practically alone in the level of turmoil in our housing markets as measured by foreclosures and delinquencies. Clearly there is a direct causal link.

By almost any measure Fannie and Freddie have not propelled the U.S. to housing finance nirvana. When compared to other modern industrialized nations – whether we look at rates of home ownership or spreads between mortgage interest rates and sovereign debt -- the U.S. can usually be found either at the middle or bottom of the pack.

However, there is one category where the U.S. clearly has led: foreclosure rates. Only in America can you find a government that subsidizes housing more, so that we, the people, get less.

But, we don't have to look overseas to see a well-functioning housing market without GSEs. Indeed, we don't have to look any further than our own jumbo market that successfully operates without them. Prior to the housing bust, the jumbo market was approximately 20% of the total housing market.

There was capital, liquidity, competition, the 30-year fixed mortgage, consumer choice and innovation – all right here in America. And all of this was delivered for about 25 basis points or a ¼ of 1% interest differential from the GSEs – a modest amount to avoid taxpayer bailouts, government control and economic catastrophe.

And, whatever modest interest rate benefit the GSEs delivered to home buyers was clearly offset to some extent by the cost of housing principal they artificially inflated for those very same home buyers. In other words, it is not self-evident that the home buyer was any better off.

At the end of the day, the best arguments that I have heard to perpetuate the GSEs are the following:

One, they were standards-setters through their underwriting purchase requirements.

Two, they served as loan aggregators for smaller lenders by purchasing loans through their Cash Window.

And, three, they provided a conduit for smaller originators to access mortgage investors through the issuance of MBS.

These are indeed functions worth preserving in some form throughout a new system. Thus, the PATH Act ushers in a new system of housing finance that separates out these functions, providing clear and transparent disclosure of mortgage data, giving certainty to contracts and their enforceability, utilizing the knowledge and networks of the Federal Home Loan Bank system, and creating an open-access utility for MBS issuance that is decoupled from the holding of long-term mortgage risks.

To ensure a smooth transition to the new system, the PATH Act implements several reforms to Fannie and Freddie in the interim. These reforms include repealing their misguided, Washington-created "affordable" housing goals that helped precipitate the crisis; shrinking their portfolios of mortgage-backed securities and other assets; and eliminating their government-granted competitive advantages over the private sector.

The PATH Act also reforms the FHA. You cannot have true housing reform without FHA reform. Otherwise you are simply squeezing one side of a balloon only to have it bulge out on another.

Today the FHA is not only broke – it is bailout broke. And over time, FHA has experienced severe mission creep. I would argue that the two phenomena are directly related. Instead of helping those it was intended for, today FHA insures mortgages for millionaires and homes valued as high as $729,750 – a mansion in most of my congressional district and far beyond the reach of those truly earning low and moderate incomes.

FHA's government-granted privileges give it advantages that muscle out private competition, so it is no wonder FHA today controls 57 percent of the mortgage insurance market. It has gained this advantage over

competitors by using many of the same practices employed by subprime lenders: small down payments, low credit scores, cheap up-front pricing, and encouraging the purchase of increasingly pricey homes.

That's why today's FHA has more in common with Countrywide than with the FHA of years ago.

The PATH Act returns FHA to its traditional mission of helping first-time homebuyers and low- and moderate-income families. It further helps ensure FHA's solvency. A bankrupt FHA helps no one.

But rest assured that in times of serious economic downturns, under the PATH Act the FHA will be able to insure loans to any borrower. This means the PATH Act would preserve the FHA's existing countercyclical role in mortgage lending, which enables the FHA to serve as a backstop to keep mortgage credit flowing, promote stability in the housing market, and ensure middle income families can still buy homes.

The PATH Act also allows for a new-but-old method for banks to finance mortgage lending by creating a regulatory framework for covered bonds financing. I say new-but-old because covered bonds have existed and been successfully used in Europe for more than 200 years, where they offer a third pathway to mortgage financing beyond traditional portfolio lending or securitization.

But when it comes to housing finance, many in Washington fight the new and defend the old – the failed status quo that gave us a government-run monopoly, taxpayer bailouts, economic crises and mediocre homeownership rates.

They claim the PATH Act will eliminate the 30-year fixed rate mortgage. That's the biggest myth they're spreading about the PATH Act. The 30-year fixed rate mortgage will continue to exist. The PATH Act won't change that.

In fact, Section 213 of the PATH Act specifically states that the "FHA shall provide, among other mortgage insurance products, for the availability of a 30-year fixed rate mortgage". Not that the FHA can provide, may provide or should provide, but SHALL provide.

It is worth noting here that Section 213 would be the first time that the FHA is ever specifically required to offer a 30-year fixed rate insurance product, which should conclusively refute the argument regarding the 30-year fixed rate mortgage.

Moreover, some people have stated that the very existence of the 30-year fixed rate mortgage is due to the creation of the FHA. If so, the PATH Act goes to great lengths to strengthen it for future generations by granting the FHA meaningful autonomy from HUD, properly defining its mission, and giving it more flexibility to manage its books.

30-year fixed rate mortgages existed before the financial crisis without a government guarantee and they are being made today without a government guarantee.

As the Washington Post recently editorialized: "Opponents of the PATH Act argue that the lack of permanent government backing will deprive the market of liquidity and consequently end the 30-year fixed rate mortgage…One answer to that is that some 30-year fixed rate loans already exist without government help…"

Home buyers should have the opportunity to acquire a 30-year fixed rate mortgage. However, Washington should not steer people into it but instead ensure they have informed choices about an array of mortgage products.

As Ed DeMarco, the head of the Federal Housing Finance Agency, recently stated: "One thing I would say

about 30-year mortgages, it is not necessarily the best mortgage product for a homebuyer, especially a first-time homebuyer. If you look at statistics and see that the first-time homebuyers in this country tend to own their first home for 4 years or for 5 years, it may not be the best for their circumstance if they buy that house with that kind of timeline…there may be a different mortgage product in which they can build equity at a faster rate than a 30-year fixed rate mortgage."

Even President Obama has acknowledged that shorter duration loans hold advantages for many borrowers, such as when he proposed last year an expanded loan refinancing program where borrowers "must agree to refinance into a loan with a no more than 20 year term."

Many Americans who seek to own a home find themselves selling their property before they build some – if any – equity, leaving their situation akin to being a renter who pays thousands in closings costs, agrees to do all the maintenance, and then has to pay the property taxes. There is no one-size-fits-all mortgage.

Next, some opponents of the PATH Act claim that sufficient private sector capital does not exist to fill a post-government guarantee void. That begs several questions. Why are our equity markets 2.5 times the size of our mortgage markets and yet they exist without any guarantee – government or otherwise? Just how much capital is "sufficient" for housing finance? I don't know the answer to that and I suspect no one in this audience knows, either. But I do know that whatever that number is, it must be sustainable. That is the key concept.

I would also remind you that capital has alternative uses. Every dollar Washington artificially incents into mortgage finance is a dollar that can no longer be used to promote math tutors for our children or promote our economy's manufacturing sector to give them jobs once they graduate.

An important fact to remember about the U.S. mortgage market is that investors—property and casualty and life insurers, pension and retirement funds, mutual funds, and real estate investment trusts—held almost 50 percent of the market share for whole mortgages and mortgage-backed securities by 2010. For these kinds of investors, the U.S. residential mortgage market is an ideal investment opportunity, given their need for long-term investments.

As housing expert Professor Dwight Jaffee of UC Berkeley has explained: winding down the GSEs "should be accomplished without any major stress in the flow of funds for U.S. mortgages."

And if we look abroad, we see in other modern industrialized nations that have avoided our disastrous GSE experiment, private capital is ready, willing, and able to fund the mortgage market.

Another false attack made against the PATH Act is it will make it harder for middle income families to buy homes. No, that distinction belongs to the Dodd-Frank Act, our current law.

Chief economist Mark Zandi of Moody's Analytics recently testified before our committee that one single Dodd-Frank rule in the pipeline could increase mortgage interest rates one to four percentage points.

Similarly, CoreLogic, a company that analyzes financial information, has said about half of the mortgage loans made today would not comply with Dodd-Frank rules that go into effect this January.

In other words, the Dodd-Frank Act could cut the number of mortgages in half and double the cost of those that remain. It's that bad.

Perhaps that's why the National Association of Home Builders has warned that Dodd-Frank "could grind the housing finance system to a halt."

Right now, because of the Dodd-Frank Act, Washington has more control over who can buy a home than your local bank. The PATH Act addresses these devastating rules head on, getting Washington out of the way to allow banks to lend, builders to build, Realtors to sell, and home buyers to buy.

The PATH Act entirely eliminates the Qualified Residential Mortgage issue by striking Dodd-Frank's credit risk retention requirements and prohibiting federal banking agencies from requiring risk retention or premium capture cash reserve accounts.

The PATH Act also eliminates the troubling ability to pay liability exposure for lenders for the mortgages they are willing to hold in their own portfolio or securitize through the platform created by the PATH Act.

Lastly, I know some have alleged the PATH Act is "ideological." But it seems to me those who defend the failed status quo of taxpayer bailouts, economic crises and mediocre homeownership rates are the ones being ideological.

Instead, the PATH Act is sustainable – sustainable for homeowners so they buy homes they can actually afford to keep; sustainable for taxpayers so they never have to bail out our housing finance system again; and sustainable for our economy so we avoid the seemingly never ending boom-bust cycles of our housing market. Perhaps in Washington that's ideological. In the Fifth Congressional District of Texas, that's common sense.

Diane from Dallas spoke some common sense when she wrote me: "Why should those of us who did the responsible thing and purchased homes we could afford have to pay the freight for those who bought larger, more expensive homes they couldn't afford?"

Steve from Jacksonville wrote me with some more common sense: "If it were a mom and pop business that did what Fannie Mae and Freddie Mac did they would have been shut down for poor business practices and even jailed."

And Scott from Mesquite wrote in to tell me: "What the American people need is not more Washington regulations or more subsidies. Just give us the opportunity to buy a home people can afford to keep so we can live and raise our families."

People outside Washington get it. They understand that the system in place today is too often unfair, unaccountable, unsustainable and robs them of opportunity to improve their lot in life.

Clearly there are other voices in this debate besides my own and my constituents. I could not be more gratified that last week the President finally added his voice to this important debate. Although I heard few specifics, I welcome him to this debate and recognize he is indispensable to a solution.

Other important voices in the debate are those of Senator Corker of Tennessee and Senator Warner of Virginia, and I commend them for their leadership. As someone who has worked for years on the complicated and contentious issue of housing finance reform, I salute anyone who works hard and produces an actual plan.

Every day more voices are being raised in this debate. This is good. I stand ready to listen and negotiate in good faith. I do this with an open mind. But it is not an empty mind.

Thus, I remain skeptical and fearful of any approach that does not end the permanent government guarantee in the secondary mortgage market.

If, at the end of the day, taxpayers are still on the hook, then I fear all you've done is put Fannie and

Freddie in the Federal Witness Protection Program, given them cosmetic surgery and a new identity, and released them on an unsuspecting public.

When government provides guarantees, it means the investors who buy mortgages or mortgage-backed securities will be protected against loss. They won't be overly concerned about the quality of the mortgages. Either way, they'll get paid. Not unlike Fannie and Freddie, it could very well perpetuate a system where Wall Street investors simply offload their risks onto Main Street taxpayers.

Such a system virtually guarantees Americans will face another round of boom, bust, and bailout.

When I hear ideas that set up new federal bureaucracies that would approve all the players in the housing finance system, I fear the prospect of powerful bureaucrats picking winners and losers. In that system, the taxpayer always comes out the loser and cronyism runs rampant.

I remain skeptical of ideas to create a new federal mortgage insurance fund. If there's one thing we've learned about government and insurance funds, it's that the government cannot or will not do a very good job of pricing for risk.

You name it, whether it's the National Flood Insurance Program – which is underwater, pun intended – the Pension Benefit Guarantee Program, even the Deposit Insurance Fund from time to time, the government has gotten it wrong and left taxpayers on the hook.

I will conclude with these thoughts. As our nation charts a path forward on housing reform, some will say our public policy choices for working Americans are between "house" and "no house." I disagree. To have a sustainable housing policy, one where people buy homes they can afford to keep, the choice is really between "house" and "more house."

Will our generation perpetuate a system that demands "more house" today only to ensure that our children are confined to "less house" tomorrow? Today's system of boom, bust, and bailout is retarding economic growth and helping fuel what all acknowledge as unsustainable levels of national debt.

Our spending-driven debt crisis is the greatest existential threat facing our nation. We are now borrowing 31 cents of every dollar we spend. Children born today are burdened with a debt of more than $52,000 they did nothing to create. Our national debt stands at roughly $145,000 per household. For many of those I represent in the Fifth District of Texas that is more than they will ever amass in savings during their entire lifetimes.

David Cote, one of President Obama's own appointees to the Presidential Debt Commission and the CEO of Honeywell, said: "The seeds of the next recession have already been planted. The debt burden accumulated over the next 10 years will sink us."

The former chairman of the Joint Chiefs of Staff, Admiral Mike Mullen, said: "The single, biggest threat to our national security is our debt." The same threat exists to our national housing aspirations.

So if you ever attend one of our Financial Services Committee hearings on Capitol Hill – and I certainly hope you will – you will see that we run a continuous, real-time display of the National Debt Clock. It serves as a constant and sobering reminder of the very serious, very real threat facing our nation. A threat that should and must loom large over every debate we engage in, especially this one.

We must also remember that the best housing program is not a subsidy, a guarantee, an interest deduction, or a tax credit. It is a job. A job that leads to a rewarding career in a dynamic, growing economy. No greater or more successful housing program has ever been devised by the mind of man than the American

free enterprise system. This we should never forget.

We should also never forget that at the dawn of America's history, it was another crony-run Government-Sponsored Enterprise that needed a bailout– the East India Tea Company – that sparked a revolution and gave birth to a nation teeming with individuals who decided to take control of their destinies.

Those patriots risked their lives, their fortunes, their sacred honor to ensure that their children would have something better – in a phrase, they risked it all to create the American Dream.

Today, in the aftermath of the destruction caused by an unsustainable housing finance system, we find ourselves once again at a crossroads. It is a moment in our history when we have to make a fundamental choice – one that will shape the future of our nation and of those who proudly call it home.

That is why this debate matters. When it comes down to it, this is not a debate over basis points or fixed-term loans. It's about freedom and opportunity.

It's about taking back control of your lives and, for many of you here, your careers in housing finance without big government interference.

It is time for a new path. It is time for our generation to preserve, for our children, the American Dream – including that most important dream of homeownership. Thank you.